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SUBJECT: THE INFORMAL COLOMBIAN ECONOMY - WHY IS IT SO PERVERSIVE?

¶1. (SBU) Summary: Despite several years of strong economic growth and economic liberalization, much of Colombia's economic activity continues to fall in the informal, unregulated and untaxed sector. Estimates of the size of the informal economy range from 48 to 60 percent of GDP, depending on how "informal" is defined. Experts attribute the continuing pervasiveness of informality to complex tax rules, difficulties in registering businesses, and a tradition of public acceptance. Nevertheless, informality poses an ongoing challenge to addressing Colombia's long-term social services imbalances, ensuring all Colombian workers have access to basic social protections, and increasing competitiveness. Although the GOC has begun to take small steps towards reducing informality, further tax, labor and business registration reforms will be needed to significantly address the structural causes of informality. End Summary

Defining Informality

¶2. (U) The challenge in addressing Colombia's high level of informality begins with the lack of a clear definition of the informal economy. While often associated exclusively with illegal economic activities or unreported economic activities intended to avoid taxes, the informal economy in Colombia more broadly consists of all economic activities that circumvent the costs, and rights, associated with commercial licensing, labor contracts, financial credit and the social security system. Recent estimates provided by both international and local institutions suggest the informal economy accounts for up to 60 percent of the total Colombian economy as a percentage of GDP. However, most estimates do not account for the illicit economy linked to the drug trade, for which economic estimates vary widely.

¶3. (U) For the Colombian National Statistics Agency (DANE), two key measures contribute to the calculation of informality: informal employment and informal enterprise. DANE reports that since 2001 informal employment has fluctuated between 57 and 61 percent of total employment--meaning the majority of employable Colombians do not have full access to legally required benefits such as social security, health care, retirement and worker's compensation. DANE reports 59 percent of all microenterprises (firms with less than 10 employees) are similarly informal and unregulated.

Causes of Informality

¶4. (SBU) According to Roberto Steiner, Executive Director of

the prominent Colombian think-tank FEDESARROLLO, excessive taxes and a burdensome tax filing system are the greatest disincentives to formalization for Colombian micro and small enterprises. According to the World Bank's 2009 Doing Business Report, Colombian firms on average spend 256 hours making a required 31 different tax payments, for a total tax rate of 78.4 percent (as a percentage of total commercial profit). The Latin America regional average is 50 percent. Comparing tax processes and tax rates of 181 world economies, Colombia ranks 141st and is less competitive than many Latin American countries. Thus, tax evasion often serves as the primary motivator for small Colombian businesses to remain in the informal economy.

¶15. (SBU) Significant administrative costs and a lack of transparency in registering businesses also impede the formalization of many small businesses. According to the World Bank's 2009 Doing Business Report, Colombia ranks 79th in business registration practices across 181 countries. On average, a Colombian will spend 36 days completing 9 procedures at a cost of 14 percent of the average Colombian's annual earnings to register a business. Ricardo Duarte, Vice-Minister of Commerce, Industry and Tourism highlighted the challenge further by telling us that simply accessing registration services remains too complicated and unavailable in many communities, creating a de facto impediment equal to the cost barrier.

¶16. (SBU) Finally, inaccurate perceptions about the actual size and impact of the informal economy have fostered widespread acceptance of informality. Imelda Restrepo de

Mitchell, Director of Economic Studies for the National Association of Industries (ANDI) told us such acceptance has allowed the informal sector to become entrenched, deepening workers' dependency on informal employment and exacerbating the need for the few large formal sector companies to subsidize social service institutions. In a recent interview in Portafolio Magazine, Steiner estimates that the five largest Colombian firms effectively pay 80 percent of all corporate taxes in Colombia. In separate discussions, Rodolfo Amaya, Executive Director of the Council of American Companies echoed Restrepo and Steiner, noting 10 percent of the entire tax base of Colombia is generated by 127 large U.S.-owned enterprises. Colombian tax policies subsidize social services with formal enterprise revenue, effectively serving as a disincentive to formalization and employment generation.

Informality's Corrosive Impact

¶17. (SBU) As a result of Colombia's extensive informality, more than 10 million workers go without formal health, worker's compensation, and retirement benefits. Moreover, the sheer size of the informal economy, and consequent lost tax revenue, affects the fiscal viability of Colombia's formal social security institutions to provide services. Previous GOC efforts to make up the shortfall between contributions and social service needs led to increasing the burden on the large companies through a set of taxes called 'parafiscales'. These taxes, equivalent to 9 percent of a firm's cost of labor, currently finance Colombian institutions responsible for workers' compensation, the National Training Service (SENA), and the Colombian Institute of Family Welfare (Bienestar Familiar - ICBF). Steiner notes that in part due to the parafiscales, for every 100 pesos a firm pays an employee, the real cost to the employer is 160 pesos.

Alejandro Gaviria, Dean of Economics at the University of the Andes, told us the parafiscales have created an informality trap--serving as a disincentive for firms to register, report income, pay taxes, or invest in salaried/skilled labor, rather than a solution to the social security fiscal dilemma.

¶18. (SBU) In addition to the social and fiscal implications, experts blame informality for impeding Colombian competitiveness. Specifically, firms participating in the

informal economy do not have equal access to financing, international markets, or subsidized training. Dr. Pedro Villabon, Director of Microenterprise Banking at Colombia's National Development Bank (BANCOLDEX) told us Colombian firms operating informally lack access to financial services, restricting their ability expand, minimize fluctuations in cash flow, and invest in new technologies or skilled labor. Informal firms also lack legal recourse to pursue payments, resolve claims, or participate in government procurement - a significant part of the Colombian economy. ANDI Director of Economic Studies Restrepo added that Colombian firms competing internationally are at a disadvantage when their production chains are unavoidably wedded to informal sector suppliers that face no legal recourse for failing to deliver on time, breaking contracts, or producing inconsistent quality products with poorly trained staff. Formal taxpaying firms are disadvantaged further, lacking access and control over revenues. According to the 2009 World Bank Doing Business in Latin America report, comparing economies of 17 Latin American countries, Colombia is average in level of effort needed to pay taxes. However, Colombian firms pay a total tax rate of 78.4 (as a percent of commercial profits) ranking second from last (exceeded only by Argentina). This places Colombian firms at a distinct regional disadvantage comparing firms, abilities to leverage and invest profit.

Finding a Way Forward

¶9. (SBU) Recognizing that the heavy tax burden and complex business registration requirements have fueled informality, the GOC has begun to take small steps to address the root causes. On May 27, 2009, Colombia's tax authority initiated a scaled labor tax payment system for all businesses.

Previously, a firm was responsible for paying 100 percent of all labor taxes for an employee, regardless of the number of hours the employee worked per month. Under the new system,

firms will report the number of hours an employee works per month as a percentage of full-time employment, and pay the equivalent percentage of labor taxes. The aim is to lessen the tax burden firms associate with formalizing labor and encourage investment in salaried/trained labor. However, Vice-Minister Duarte admitted that this policy is only a "second-best solution" next to eliminating parafiscales and finding collection efficiencies within the existing tax base to pay for social programs. Duarte acknowledged that scaling taxes based on part-time but permanent labor could help encourage investment in labor, reporting of actual number of employees and increase tax revenue. But he also warned the policy still encourages under-reporting of employees and creates additional administrative burdens for GOC tax authorities. Steiner advises getting rid of special tax schemes, folding parafiscales into normal tax structures, and working to increase the tax base rather than unfairly burden firms that do pay taxes.

¶10. (SBU) Outside experts such as Gaviria say the GOC should broaden policies to incentivize formalization, including tax cuts for firms that generate employment, rather than raise taxes on existing formal firms that do pay taxes now.

Santiago Levy, Director of Research for the Inter-American Development Bank specifically blames the parafiscales for "trapping the poor in poverty". Colombia's small formal sector bears a disproportionate burden of financing social service institutions. Gaviria told us that a more appropriate approach would be to lower taxes and make labor rules more flexible, thereby lowering the cost of hiring permanent employees and registering them with social service institutions.

Comment

¶11. (SBU) Colombia has made progress in recent years reducing poverty through growth and liberalization. However, pervasive informality remains arguably the most significant bridle to

broad poverty reduction in Colombia and ensuring an adequate social security net for all Colombians. While the small steps so far to reduce barriers to formalization are headed in the right direction, a broader paradigm shift away from heavy taxation and rigid bureaucracy will be necessary to truly break the cycle of informality.

Brownfield